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AUG 18 2004

No. 03-892/03-907

IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN W. BANKS, II,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIGITAS J. BANAITIS,
Respondent.

On Writ of Certiorari
To the United States Courts of Appeals
For the Sixth and Ninth Circuits

BRIEF FOR *AMICUS CURIAE* PROFESSOR CHARLES DAVENPORT IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICUS CURIAE*

This *Amicus Curiae* is a professor of law at Rutgers University, Newark, New Jersey. *Amicus* offers a theory not argued in the courts below. He has written a book on tax accounting, a book on the determination of cost for inventories, and, with another author, a second book on inventory costs. His interest lies in the proper application of tax doctrine. He has no other interest in the outcome of these cases.[1]

SUMMARY OF THE ARGUMENT

The cases at bar may be resolved by application of fundamental principles of federal income tax accounting not urged below by any of the parties.

The legal fees in these cases were incurred to acquire and dispose of Respondents' tort claims against their employers. Tort claims are intangible property. The costs of acquiring and disposing of property are transaction costs, and transaction costs are not deductible under either section 162 (dealing with business expenses) or 212 (dealing with investment expenses) of the Internal Revenue Code.[2] Rather, transaction costs are offset directly against the proceeds

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[1] Pursuant to this Court's Rule 37.3(a), letters from all parties consenting to the filing of this brief have been filed with Clerk. Pursuant to this Court's Rule 37.6, *Amicus* states that this brief was not authored in whole or in part by counsel for any party. *Amicus* received no monetary contribution for the preparation or submission of this brief other than reimbursement for the cost of printing this brief from Tax Analysts, a tax-exempt, nonprofit educational organization that has no interest in these cases but is interested, as a part of its exempt function, in sponsoring full debate on important tax issues. The views presented in this brief are those of the *Amicus* and should not be ascribed to either Tax Analysts or Rutgers University.

[2] 26 U.S.C. References to section numbers are to the Internal Revenue Code of 1986 unless otherwise noted.

earned by the costs. Because the fees are not deductions, they do not fall within the ambit of deductions disallowed in computing the alternative minimum tax (AMT).

The tax rules just stated are well-recognized, familiar tax doctrine routinely applied for many years. These rules provide certainty, and we need not set out on an endless sea to find another set of rules or perhaps to invent a new set of rules for these cases. The rules for transaction costs properly match costs against income. These rules are also administratively convenient. Finally, neither Petitioner nor *Amici Curiae* Professors Polsky and Hellwig give any good reason not to apply the rules for transaction costs to the cases before the Court. (Professors Polsky and Hellwig will be referred to as *Amici*.)

Petitioner's argument concerning assignments of income is fundamentally flawed. It relies on doctrine announced in cases of gratuitous assignment of income. Gratuitous assignments arise in friendly transactions where the only constraints on the form of the transaction are family wealth, family control, and hoped-for tax results. These circumstances justify careful scrutiny, and at the request of the IRS, the courts have developed unique rules for gratuitous assignments of income. These special rules are inapposite and should not be applied to assignments for consideration. Assignments for consideration are subject to well-developed income tax doctrine easy of application in these cases. As explained in the Argument below, Petitioner has issued recent rulings that flatly contradict its position in these cases.

Amici argue that IRC section 83(h) allows a deduction for the legal fees in these cases. It does not because the legal fees at issue are nondeductible transaction costs. The overriding principle that transaction costs may not be deducted is as applicable to IRC section 83(h) as it is to IRC sections 162 and 212. *Amici*'s reliance on section 83(h) is misplaced.

The theory set forth in this brief will achieve the right legal and the right economic result. The legal result follows from the argument above. The economic result is right because the income that is taxed under the AMT will be exactly equal to the economic benefit that the taxpayers received from their lawsuits. They will not be taxed on amounts far in excess of their economic gains as they will be under Petitioner's and *Amici*'s arguments.

ARGUMENT

I. Taxpayers' Legal Fees Are Transaction Costs, Not Deductions

A. Taxpayers' Tort Claims Are Property

These cases involve damage to a taxpayer's person but without physical injury and do not involve "personal injuries" within the meaning of section 104(a).[3] Even so, in tax literature, the injuries like the ones in these cases are sometimes called personal injuries.[4] This parlance prevails because the injury is to the person and results from tortious or quasi-tortious[5] conduct as distinguished from breaches of contracts.[6]

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[3] *United States v. Burke*, 504 U.S. 229 (1992), 122 S.Ct. 186, 119 L.Ed. 34; *Commissioner v. Schleier*, 513 U.S. 323, 115 S.Ct. 2159, 132 L.Ed. 294 (1995); *Ogilvie v. United States*, 519 U.S. 579, 117 S.Ct. 45, 136 L.ED. 454 (1996); and section 104(a) as amended.

[4] Raby, Burgess J.W. and William L. Raby, "Getting the IRS to Pay the Costs of a Tax Controversy," *Tax Notes*, July 12, 2004, page 173.

[5] The term "quasi-tortious" conduct is used because many of the taxpayers in cases presenting the issue before this Court founded their claims on statutory provisions conferring rights that had not been recognized by the common law. These cases are cited on page 3 of Brief for *Amici*.

[6] The argument in this brief is limited to cases of tort or quasi-tort injuries to the person. Broader application, if appropriate, may await another day. The cases in note 3 *supra* demonstrate the Court's familiarity with distinction between torts and contracts. Here the distinction is urged not to afford exemption from tax, but to define a class of cases that is well

These injuries to the person produce tort claims, and tort claims are property. In *Dames & Moore v. Regan*, 453 U.S. 654 (1981), this Court held that a cause of action could not be taken without compensation. Similarly, this Court has held that a tort claim may not be taken without due process. *New York Central Railroad Company v. White*, 243 U.S. 188 (1916). Even wispier intangibles are readily accepted as property in the tax law. For example, a customer-based intangible, a supplier-based intangible, know-how, a process, a format, or other similar items are recognized as property.[7] In *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), a mere future benefit (presumably from corporate synergies flowing from a merger) was enough to be treated as property.

Perhaps, Petitioner[8] will argue that injuries associated with one's person are not property because, if their disposition produces income, the income is ordinary income.[9] The argument seems to be that property unable to be converted to capital gain is somehow different, to the point of not being property at all, from property that may produce capital gain. Agreed. But only for the capital gain rules.[10] But the question whether or not the taxpayers' income is capital gain is not

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understood both by the Court and lower courts.

[7] See section 197(d) codifying prior practice.

[8] *Amici* argue that section 83 applies to the causes of action in these cases. Because section 83 applies only to property, an argument that the causes of action in these cases are not property would seemingly be difficult for *Amici* to sustain.

[9] Hellwig, Brant J., "Tax Treatment of Legal Fees: The Debate Continues," *Tax Notes*, Dec. 2, 2002, page 1235 and Brant J. Hellwig, "Davenport's Capitalization Argument Fails to Convince," *Tax Notes*, Jan. 20, 2003, page 433.

[10] *Hort v. Commissioner*, 313 U.S. 112, 61 S.Ct. 757, 85 L.Ed. 1168 (1941), *United States v. Midland-Ross*, 381 U.S. 54, 85 S.Ct. 1308, 14 L.Ed.2d 214 (1965). *Commissioner v. P.G. Lake, Inc.* 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), *reh. denied* 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071.

before the Court,[11] and the distinction has nothing to do with whether the taxpayers' causes of action are property for other purposes. Certainly, many items whose characterization as property cannot be contested produce only ordinary income when sold.

If the argument is as stated in the last paragraph, it brings a very difficult capital gain issue into the very difficult AMT arena, making the AMT arena even more difficult. Just why capital gain lore, a thorny thicket, should be mixed with the AMT is unclear. The only apparent reason for mixing capital gain doctrine with the AMT is to prevent characterization of the taxpayer's causes of action as property and thus to refute *Amicus*'s argument, below, that the rules on acquisition and disposition of property apply to these causes of actions. If those rules do not apply, so Petitioner may argue, the AMT applies to taxpayers' acquisition and disposition of their tort claims. There is no other demonstrable benefit.

B. The Undisputed Treatment of Transaction Costs

Once the taxpayers' tort claims are properly characterized as property, a entire new vista for tax treatment opens up.[12] It is that the legal fees are transaction costs, and it has been with us since the beginning of the income tax. What is that vista? It is that the legal fees are transaction costs, and transaction costs are not deductible. Section 263; Reg. § 1.263(a)-1(b) and Reg. § 1.263(a)-2(e).[13] Instead, transaction

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[11] That question is not before the Court. Time enough to deal with it if it should arise. *Amicus* doubts that it will arise. The case cited by *Amici* would then be relevant.

[12] Logically, there is little reason to limit the doctrine of capitalization of transaction costs, to property. Rather, a properly defined transaction would be the limitation, but *Amicus* does not in this brief argue for application of the doctrine beyond an item properly characterized as property.

[13] Reg. refers to regulations issued under the Internal Revenue Code of 1986 unless otherwise defined.

costs related to the acquisition and disposition of property are offset against the recovery they produce. Only the remaining amount is included in income.

If the transaction is an acquisition, costs are added to the basis of the acquired property. *True, Jr. v. United States*, 894 F.2d 1197 (10th Cir. 1990) and Revenue Rulings 69-561, 1969-2 C.B. 25 and 68-528, 1968-2 C.B. 331. If the transaction costs are related to the disposition of property, they are subtracted from the proceeds of the disposition with only the remaining amount being realized as income.[14] *Helvering* v. *Union Pacific*, 293 U.S. 282 (1934, *reh. denied* 293 U.S. 630 (1934) and *Spreckels v. Commissioner*, 315 U.S. 626 (1942). This treatment of transaction costs has been undisputed in the 91 years that the income tax has been with us. Generally, this disallowance of deduction is, and will in this brief sometimes be, called the capitalization doctrine. The Court dealt with it extensively in *INDOPCO, Inc. v. Commissioner, supra.*

This treatment is predicated on statutory language that, in 1913, appeared and still today appears to deal only with the acquisition costs. Section II,(B), *sixth,* Act of 1913, 38 Stat. 114, disallowed deductions for "any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate." Substantially, the same language is found in section 263(a)(1) of the Internal Revenue Code of 1986. Despite the apparent limitation to

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[14] The Internal Revenue Service has been a bit wobbly whether the transaction costs offset the proceeds directly or are first added to basis and then subtracted as basis from the proceeds to reach the amount of income to be reported by the taxpayer. *Compare*, for example, IRS Publication 523, page 3 (offset to proceeds) to IRS Publication 544, page 4, and Regulation § 15a.453-1(b)(2)(v) (included as an addition to basis). *See also Kirschenmann v. Commissioner,* 488 F.2d 270 (1973), where the IRS unsuccessfully contested the addition of selling expenses to basis but argued that they should reduce the amount realized. For present purposes, either technique is acceptable.

acquisitions, it is applied both to acquisition costs and disposition costs. *True, Jr. v. United States, supra, Helvering v. Union Pacific*, 293 U.S. 282 (1934), *supra*, and *Spreckels v. Commissioner, supra.*

Application of this doctrine to the instant cases means that the legal fees are not deductions. Rather, they are transaction costs subtracted from the litigation or settlement proceeds received by the taxpayers. Only the amount left over is included in income. The alternative minimum tax is not implicated because there are no deductions to be disallowed by sections 56(b)(1)(A).

These rules for acquisition and sales of property may be demonstrated by an example, here explained in terms of the purchase and sale of real estate rather than tort claims because *Amicus* believes that Petitioner will not dispute application of these rules to real estate. The example will explain the difference between treating transaction costs as subject to capitalization (*Amicus*'s theory) and the deduction of transaction costs (Petitioner's position).

Suppose A buys a parcel of land for $900. A also pays a lawyer for negotiation of the purchase and incurs recording and title insurance costs. Together the legal fees and other payments are transaction costs, and assume that they total $100. They are not deductible. Rather, A must capitalize both the $900 purchase price and the $100 of transaction costs. A gets a basis of $1,000 for the total of the purchase price and the transaction costs. Suppose that A sells the parcel for $1,500. Assume also that A hired a real estate broker to make the sale and a lawyer to close the transaction. Suppose that the broker was paid $90 and the lawyer $60. These items total to $150, and they are transaction costs under the law. When A calculates profit, A will reduce the $1,500 price received by the $1,000 cost plus the $150 of transaction cost incurred on the sale. A will have gross income of only $350 (whether characterized as capital gain or ordinary income). This result accords with the economics of the

transaction. A is ahead by $350, and that is what A is taxed on. These results are undisputable under present law, and the result is not changed if A is subject to the AMT.

Amicus believes that Petitioner and *Amici* would agree about the acquisition costs and that A would have a basis of $1,000 for the parcel of land. Their theory, which *Amicus* believes they would not apply to real estate but do apply to taxpayers' tort claims, would not allow the disposition costs to offset the proceeds of sale. Rather, when the parcel is sold for $1,500, the basis would be subtracted, and A would have $500 of gross income. If the property produces capital gain, A will have a capital gain of $500. Under the regular tax, A would be allowed to deduct the $150 of transaction costs against any income that A had, but this deduction would not be allowed for AMT purposes. Under the AMT, if Petitioner and *Amici* are right, A would have $500 of income although A is ahead economically by only $350.

The law indisputably requires capitalization of transactions costs on voluntary sales of property and also on involuntary sales. *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995). Also, on injuries to property. *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947). The question posed by the cases at bar are whether these clear, uncontested rules for transaction costs should be applied to Respondents' causes of action or whether the transaction costs are to be converted to deductions. If that occurs, the deductions will be disallowed under the AMT, and Respondents will be subject to tax on much more than they gained economically from the lawsuits.

C. The Legal Fees in These Cases Are Transaction Costs

The legal fees in the cases at bar are either acquisition costs, disposition costs, or both. The taxpayers had a right, created either by common law or by statute, violated by tortious conduct. Legal fees were incurred to establish the violation of a right, to show the extent of the damage, and

finally to settle on the amount due the taxpayers. These fees were costs. They are directly traceable to a discrete, recognizable transaction. The fees were necessary to the acquisition of property, the causes of action, and the lawyers' services disposed of this property by obtaining payment from the defendants in the civil lawsuits.

The most recent definition of acquisition costs state that an expenditure is a cost if it facilitates a transaction. Reg. § 1.263(a)-4(e)(1).[15] Certainly, the legal fees in question here facilitated the acquisition and disposition of the causes of action. Typically, an expenditure becomes an expense rather than a transaction cost if it is an indirect cost that cannot be traced to a specific transaction but rather might have enabled a number of different transactions and produced a number of different benefits.[16]

The legal fees in the present cases are very similar to those incurred in *Baylin v. United States, supra*. In *Baylin*, Mr. Baylin had property taken by the State of Maryland. He was unable to contest the taking of the property, just as the taxpayers in these cases were unable to contest the damage inflicted upon, and both the taxpayers and Mr. Baylin were left to post-injury damages. When the State did not offer what Mr. Baylin thought was sufficient, he went to court and contested the amount. He prevailed and recovered a much

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[15] These regulations do not deal with disposition costs and cannot be expected to define a disposition cost. One supposes amounts paid to facilitate a disposition would be treated as transaction costs because that treatment is consistent with the long history of the income tax and the regulations on acquisitions.

[16] For example, the IRS has issued a number of regulations related to indirect costs of inventories, and in 1986, the Congress required indirect costs to be capitalized as a part of the costs of property in accordance with section 263A. Section 803 of the Tax Reform Act of 1986, P.L. 99-514. These prior regulations can be found at Reg. § 1.471-3, T.D. 6336, Nov. 25, 1958, and T.D. 6500, Nov. 9, 1960, amended by the T.D. 7285, and Reg. § 1.471-11, T.D. 7285, Sept. 14, 1973.

larger sum than the State had offered. His legal fees were subtracted from the award from the State, and he was taxed upon the proceeds reduced by the legal fees. So clear is the result[17] in *Baylin* that the Petitioner's and *Amici*'s citation[18] of it as supporting them is inexplicable.

In *Alexander v. IRS*, 72 F.3d 938 (1995), cited by both Petitioner and *Amici* as supporting their positions, the Court of Appeals for the First Circuit did not allow a taxpayer to offset legal fees against a settlement. The court did not adopt the analysis made here, but one circuit court opinion should not be dispositive of one issue.

The similarity of these cases to the taking of property in *Baylin v. United States*, *supra*, argues strongly for application to the cases at bar of the well-developed rules applied in *Baylin v. United States, supra*. There is no articulated reason for not applying *Baylin*.

D. The Disallowance of Deductions for Transaction Costs Has Several Merits

Transactions cost are properly disallowed as deductions. Disallowance of deductions produces a matching of cost against its associated income. Matching of income and cost is an important doctrine of income taxation and a fundamental principle of accounting. Matching prevents the separation of costs and income for the benefit of either taxpayers or the government. The capitalization doctrine also can prevent transaction costs related to the earning of capital gain income from being deducted against ordinary income.[19] By the

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[17] The court in *Baylin* said: "The IRS classified all of the legal fees as a capital expenditure and calculated a capital gain . . . by adding all of the legal fees to the basis of the condemned property. . ." at page 1453.

[18] *See* Petitioner's brief at page 23 and *Amici*'s brief at page 3.

[19] *See* the example in text above.

capitalization doctrine, transaction costs are given the same character as the income earned by them.

The administrative convenience is important if the statute does not demand inconvenience, and as argued in the pages below, it does not in these cases. Under the capitalization doctrine both taxpayers and the government have their burdens minimized. They do not have to determine whether transaction costs are deductions falling into itemized deductions and allowed only if they exceed the standard deduction. Or whether they constitute business or nonbusiness deductions. Or, for that matter, get into the determinations made in these cases.

Neither Petitioner nor *Amici* have argued that they reach a proper economic result. They must acknowledge that under their theory, after application of the AMT, taxpayers will be taxed on amounts far greater than their economic income - sometimes, even to the point that the taxpayers' costs and taxes exceed the amount of the recovery. That their results are harsh is not, of course, an argument against them if that is what the statute requires. But Petitioner cannot point to any language in the statute (either the AMT provisions or sections 162 and 212) that mandate Petitioner's results. Nothing in the literature (whether committee or conference report, academic or professional journals, or learned treatises) surrounding either the passage of section 162 (business deductions, enacted as a part of the first income statute in 1913), section 212 (investment deductions, first enacted as section 23(a)(2) of the Internal Revenue Code of 1939 by section 121(a) of the Revenue Act of 1942) or sections 55-59 (the alternative minimum tax) vaguely suggests that the results pressed by Petitioner and *Amici* were perceived by a single member of the Congresses that have passed and later amended these provisions. Lack of support in the literature, of course, would not be harmful to their theory if their theory were required by the statutory language of any of the provisions just cited. But it is not, and in the absence of statutory language specifying

the results urged by Petitioner and *Amici*, this paucity of materials in the literature is telling in the face of what the Congresses must have known: Transactions costs are not deductions. There is no indication that any member of any of these Congresses ever thought that enactment of section 162, section 212, or the AMT changed the capitalization rule.

The language of the statute (sections 55-59, 162, and 212) does not demand the harsh result urged by Petitioner and *Amici*. Rather, an appropriate result taxing the taxpayer only on economic gain can be reached within the wording of the statute, and that result is consistent with tax doctrine that was reached under the original income tax act and that has prevailed since.

E. Simultaneity of Acquisition and Disposition Does Not Change Rules for Transaction Costs

This *Amicus* also thinks that Petitioner may argue that capitalization does not apply when disposition of property is almost simultaneous with its acquisition. Petitioner may argue that *INDOPCO* does not apply to cases with benefits so evanescent. While *INDOPCO* speaks of disallowing deductions for amounts paid for future benefits, the opinion is grounded on the premise that purchases of property are not deductible expenses. Analytically, the cases before the Court involve an acquisition of property through showing of an injury, a valuing of the property, and finally a disposition of the property through judgment or settlement. Each of these steps can be thought of as a separate transaction with each step having its costs capitalized. But the steps in these cases are compressed into a single moment. This compression gives no good reason for changing the rules applicable to each step. If this Court were to hold that this compression somehow makes capitalization inapposite, taxpayers sufficiently advised will effectively have an election. Separate the steps and have capitalization apply; compress the steps and have the yet-to-be-announced rule apply. The simultaneity of the acquisition, valuing, and disposition

provides no justification for this election. The compressed steps should remain subject to capitalization.

Under *INDOPCO* all expenditures are presumptively capital in nature. The simultaneity of the acquisition of a valid cause of action and its disposition should not change the *INDOPCO* presumption and transform capital expenditures into deductions. The character of expenditures should not turn on the order and timing of incurrence and disposition.

Amicus thinks that reply briefs may possibly question the application of the capitalization doctrine by arguing that drawing a line between transaction costs and deductions will be difficult and that the Court should not introduce that kind of uncertainty into the tax law. This difficulty is avoided, so the argument may run, by treating all expenditures as deductions. *Amicus* responds that doctrine should not be so cavalierly overridden. There is no uncertainty in the instant cases. This Court's opinion upholding *Amicus* position would not introduce uncertainty. The Court would simply be hewing to a line between transactions costs and deductions that already exists for the very important reasons set out above.

II. Petitioner's Reliance on Cases of Gratuitous Assignments of Income Is Improper[20]

A. The Assignments in These Cases Are Not Gratuitous Assignments

In its argument that taxpayers should include all of the recoveries in income, Petitioner relies on venerable, reliable, and still authoritative (except to the extent changed by subsequent statutes) opinions of the Court. The seminal case was *Lucas v. Earl*, 281 U. S. 11 (1930). In 1901, well before the enactment of the income tax in 1913, Mr. Earl assigned

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[20] The Petitioner is correct that the tax treatment of legal fees is a matter of federal law. It should not vary from state to state. Treating legal fees as transaction costs will achieve this national uniformity and obviate the difficult analyses made by the courts below.

one-half of all of his subsequent earnings to his wife. After enactment of the income tax, Mrs. Earl paid, and Mr. Earl did not pay, tax on the earnings she received under the assignment. In a progressive income tax, the Earls' splitting of income reduced the overall tax. This treatment was challenged by the government. It argued that Mr. Earl could not avoid taxation on his earnings by giving them away to a family member. The Court agreed. Subsequently, in *Helvering v. Horst*, 311 U.S. 112 (1940), this doctrine was applied to interest income on a corporate bond that Mr. Horst gave to his son.

These holdings were necessary to prevent evisceration of the income tax through intra-family arrangements that arbitrarily sought to shift income from family member to family member in accordance with need or the tax brackets of the donor and the recipient without substantially changing the net wealth or income of the family as a whole.

The assignments of income in the cases before the Court are quite different. They were made for consideration. Each party bargained to obtain the best deal available. Self-interest on each end of the bargain gives quite a different cast to the rules that are applied.

Here is how these well-developed rules apply to assignments for consideration. The assignor (taxpayers in these cases) is taxed on the receipt of consideration. If the consideration cannot be valued when the assignment is made, taxation is deferred until it can be valued. Once the consideration is valued and included in income, the assignor receives a basis for the consideration. This basis is equal to the value of the consideration received. The assignee is taxed on the assigned income.[21] These rules are appropriate for the

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[21] These rules have produced some difficulty when the assigned interest is a carved-out interest. *See for example*, sections 167(e), 636, 1001(e), 1286, and 7872(b), and *Hort* v. *Commissioner*, *supra* note 10, or *Commissioner v. P.G. Lake, Inc.*, *supra* note 10. But these statutory

cases at bar. The negotiation between a client and a lawyer do not produce gratuitous assignments. Rather, the client's assignment of a part of the prospective recovery is for value - the lawyer's promise to advocate the client's case.

The inclusion in income of the value of the services gives the client a basis for the legal services, and the services and the basis given them have in turn been expended in obtaining the balance of the settlement or judgment.[22] This is unexceptional income tax doctrine. It should be applied to the assignments in the cases at bar.[23]

B. Petitioner's Recent Rulings Contradict Petitioner's Position

Petitioner's argument about assignments of income is maintained in this Court despite two recent rulings that flatly

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enactments have not changed the rules except as provided by the statutes, and few would argue that either *Hort* or *Commissioner v. P.G. Lake, Inc.* is wrongly decided. *Estate of Stranahan*, 472 F.2d 867 (6th Cir. 1973), also presented a carved-out interest with consideration in a friendly, family situation. In cases at hand, the interest assigned is not a carved-out interest but a vertical slice of the entire package of future income. If one might make an analogy to gratuitous assignments by saying that carved-out assignments are the *Earl*, *supra*, and *Horst*, *supra*, cases while the vertical slice is *Blair v. Commissioner*, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465 (1937). This is not to suggest that the gratuitous rules apply but that a dichotomy between carve-outs and vertical slices arises in commercial assignments as well as gratuitous assignments.

[22] We should not be troubled that the client may under some circumstances take it all back by firing the lawyer. If that occurs, the process starts over once again when a new lawyer is hired. This revocability might lay the basis for an argument that the assignment is a carve-out. But the assignment is no longer revocable when value can be ascertained, and, for present purposes, there is little difference between carve-outs and vertical slices. Note 21, *supra*, suggests that commercial carve-outs have required legislation to prevent manipulation. One could hardly argue that manipulation would be less with the rules for gratuitous assignments.

[23] Cf. Brief of the *Amici*, pages 7-13.

contradict Petitioner's position in this Court. In private letter ruling 200344022 issued July 24, 2003, (and released to the public on October 31, 2003), the IRS ruled that plaintiffs in a class action lawsuit did not realize the amount of the legal fees paid to counsel. The IRS reasoned that because the plaintiffs had no contract with the lawyers, the fees were not included in the plaintiffs' income. If this Court upholds the IRS in the cases at bar, the distinction arising from this private letter ruling will encourage class action lawsuits. It would also, apparently, distinguish between the plaintiff hiring the lawyers in a class action suit (who have a contractual relationship with the lawyers) and other plaintiffs, who also benefit from the lawyer's services. If this Court upholds the IRS in the present cases, plaintiffs with the initiative to hire lawyers will be subject to tax under the AMT, but the more supine, less aggressive plaintiffs who lie back to benefit from the class action will be exempted from the AMT.

In private letter ruling 200427009 (issued March 19, 2004, just a few days before certiorari was granted in these cases and released to the public on July 2, 2004), the IRS ambivalence about its position in this Court is even more apparent. The taxpayer, in this ruling, a plaintiff in a lawsuit, while recovery was still contingent on successful prosecution of the action, assigned a portion of a recovery, if any, to a second party in return for the second party's foregoing claims against the plaintiff. The IRS said that the portion of the settlement paid the second party was not included in the plaintiff's income as long as "recovery on such claim is doubtful or contingent" at the time of the agreement with the second party. Petitioner cannot, *Amicus* suggests, square this ruling with its argument in this Court.

III. The *Amici Curiae* Brief of Professors Polsky and Hellwig

Most of the analysis in this brief does not differ from or is not in conflict with that made by *Amici*. Divergence occurs only on the question whether the amounts paid to taxpayers'

lawyers were transaction costs or deductions. In support of their argument that the expenditures were deductions, *Amici* point out that section 83(h) allows a deduction under IRC section 162 for amounts subject to section 83. They go on to assert that the sharing of the proceeds of the litigation with the lawyers is subject to section 83 and thus the language of sections 83(h) makes the legal fees deductions. They do not point out that the deduction allowed by section 83(h) is subject to the capitalization doctrine just as deductions under sections 162 and 212 are.

This result is made explicit by Reg. § 1.83-6(a)(4) which prohibits a deduction for a capital expenditure. This prohibition is consistent with *INDOPCO*, the overriding of sections 162 and 212 by section 263, and the analysis in this brief.

IV. Conclusion

The legal fees in these cases are transaction costs, not expenses. The line between a transaction cost and an expense is not always easy to find, but in these cases it is bright. Transaction costs are expenditures that facilitate the transaction. Reg. § 1.263(a)-4(e)(1). The legal fees at issue were incurred to value the rights taken from taxpayers and then to dispose of the taxpayers' causes of action arising from tortious behavior. That is very similar to the taking and valuing of the property in *Baylin v. United States, supra*. The legal fees were not deductible in that case, and they are not in these cases. They are transaction costs directly traceable to proceeds, and they should be offset against the proceeds in accordance with established income tax doctrine—as old as the income tax itself.

Only expenses are subject to disallowance under the AMT, and the legal fees subject of this proceeding are not expenses.

The judgments of the Sixth and Ninth Circuits should be remanded for proceedings consistent with the Court's opinion treating the legal fees as transaction costs, not as deductions.

Respectfully Submitted,

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August 2004

APPENDIX

IRC § 56(b) Adjustments applicable to individuals. —

In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax:

(1) Limitation on deductions
(A) In general
No deduction shall be allowed. —

(i) for any miscellaneous itemized deduction (as defined in section 67(b)) . . . .

* * *

IRC § 67(b) Miscellaneous itemized deductions. —

For the purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than —

[There follows a list of exceptions not relevant to these cases.]

IRC § 162(a) In general. — There shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

* * *

I.R.C. § 197(d) — Section 197 intangible. —
For purposes of this section —

(1) In general

Except as otherwise provided in this section, the term "section 197 intangible" means —

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) work force in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(2) Customer-based intangible

(A) In general

The term "customer-based intangible" means —

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) Special rule for financial institutions

In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) Supplier-based intangible

The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

* * *

IRC § 212 Expenses for the production of income. — In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or. . .

I.R.C. § 263 — Capital expenditures

(a) General rule

No deduction shall be allowed for —

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

* * *

Treas. Reg. § 1.263(a)-1(b) — In general, the amounts referred to in paragraph (a) of this section include amounts paid or

incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph . . . . Capital expenditures are subsequently recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, at such time as the property to which the amount relates is used, sold, or otherwise disposed of by the taxpayer, in accordance with applicable code sections and guidance published by the secretary.

Treas. Reg. § 1.263(a)-2(e) — Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

Treas. Reg. § 1.263(a)-4(e)(1) — Scope of facilitate —

(i) In general.

Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

Treas. Reg. § 15a.453-1(b)(2)(v) — Gross profit defined.

. . . For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. . . .